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Chairman

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Mr Jaime Caruana
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Dear Mr Caruana

THE THIRD CONSULTATION PROCESS "CP3"

Thank you for the opportunity to comment on the latest proposals for Basel 2.

By way of background, the Royal Bank of Scotland Group is the fifth largest bank in the world. We operate in twenty countries, focused within the UK, the EU, the US and Asia.

Whilst we support the Basel Committee's attempt to address the known problems with Basel 1, we do not think that the Basel 2 framework, as currently proposed, meets the Committee's original objectives. Like many in the industry, we remain concerned that serious issues of structure and substance remain outstanding.

The root cause of many of our concerns lies in the complexity of the proposals. We believe those concerns are increasingly being shared by our supervisory colleagues. There is a very real risk that the current level of complexity will impact, now and in the future, the ability of banks to manage risks, the ability of supervisors to supervise, and the capacity of markets to evolve and adapt. These are not trivial flaws.

This response outlines a number of structural issues and concerns that should be addressed before finalising the new regime. Against this background, the attached paper makes a number of suggestions to make the Accord more flexible, to improve the cost:benefit analysis for firms and reduce the pressure on regulators. The response is not exhaustive; rather it is designed to highlight our key issues and concerns.

We have a final opportunity to improve Basel 2 and make it applicable as a global standard. Whilst the revolutionary "big bang" approach to regulatory capital might be appealing, a more measured, evolutionary approach is in all our interests.

Yours sincerely

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BASEL COMMITTEE - CP3
31st July 2003

STRATEGIC CONCERNS

RBS believe that there are six key areas of strategic concern raised by the current proposals, as discussed below.

1) Complexity.

The Pillar I rules are highly complex and have developed beyond the level needed for sensible capital regulation. As a result, there is a real risk that key stakeholders - bankers, regulators, investors and market commentators, will also not fully understand these proposals or be able to compare the performance of banks operating within and across different markets.

2) Consistency of Implementation.

Despite the positive endeavours of the Accord Implementation Group (AIG), we believe that it will be very difficult for supervisors to regulate the Accord in a consistent manner. The early signs are not good as supervisors in local markets adopt their own approaches and strategies.

There are already a plethora of tailored solutions; an American approach mandated for a dozen or so large banks and simplified versions for emerging market countries. Even within the EU, where banks operate within the rules of the Single Market, regulators do and will continue to take different approaches. There is a real risk that such localised solutions undermine the principle of the level playing field. For banks and regulators alike, the balance between practicality and flexibility is at risk of being lost.

3) Impact on Risk Management.

While the Accord is intended to support better risk management, we are concerned that one unintended consequence will be the stifling of innovation in risk management. Improvements in risk management can be fast moving. Without greater flexibility built into the Accord, sections of the new rules run the risk of being obsolete by implementation in 2007. Is this really the behaviour the Basel Committee is trying to encourage for an Accord that may still be operational in 2020?

4) Arbitrage & Regulatory Stretch.

Basel 1 is simple; arbitrage opportunities are few in number but large in effect. Equally, banks and regulators know about these opportunities. As currently devised, Basel 2 creates many arbitrage opportunities and the combined effect is unqualified. It is highly likely that banks will direct resource at minimising capital, and maximising profit opportunities through regulatory arbitrage.

Basel 2 will create an environment where banks are tempted to tamper with their internal estimates, especially if their commercial ambitions risk being constrained by tight capital ratios. The regulatory capital numbers are highly sensitive to even the smallest change in Loss Given Default and Probability of Default which are derived and largely self-assessed by banks. For example, typically across retail, a 10% improvement in LGD will result in a reduction in capital of more than 10%.

Some banks will take advantage of these new opportunities. Regulators may not have the quantity and quality of staff to effectively police the system on an on-going basis. Where are they going to find them? Basel 2 is undoubtedly more risk sensitive, but at what cost?

5) Calibration & Incentives.

While the high-level results of QIS3 support the Basel Committee's objective of maintaining the level of capital in the banking system and providing incentives for banks to adopt the more "advanced" approaches available within Basel 2, these incentives break-down below this. As highlighted in the Institute of International Finance's (IIF) analysis of the QIS3 results, such incentives do not occur at the portfolio level, where calibration leads to various 'cliff effects' and perverse incentives.

Equally, it is difficult to see how QIS3 provides comfort that the total capital in the banking system will remain unchanged. QIS3:

a) Does not take into account the impact of the proposed capital floors;
b) Was undertaken on a best efforts basis - we know from discussions with regulators and industry groups that banks have used a wide range of assumptions and workarounds as inputs to their calculations;
c) Does not reflect the changes proposed around "stressed Loss Given Defaults", the impact of which remains to be assessed.

6) Theoretical Underpinnings & Data.

Lastly, and perhaps most importantly, Basel 2 gives rise to a number of issues around data and data availability, as the overall design is heavily dependent on risk management models that themselves are validated against historical data. History, on which Basel 2 capital estimates are based, is not always a good predictor of future performance. It is the rare, unpredictable event outside the statistical norm that typically causes problems.

Banks do not have the same quantity of data for all portfolios. The rules based approach for estimating losses can never accurately capture the likelihood and impact of defaults in good quality portfolios (e.g. large corporates), which are characterised by a low number of defaults and high exposures. Different portfolios do not behave in the same way and cannot, realistically, be assessed on the same basis. Data sharing will not solve these problems.

The assumptions that good risk <u>measurement</u> constitutes good risk <u>management</u>, and that banks employing extensive use of internal models for measuring risk and allocating capital are better managed, are not well founded based on historical evidence. The technical challenge of the new Accord has been significantly underestimated.

Summary

From the point of view of implementation, there is a real risk that the focus of resources will shift from actual risk management activities to rules compliance; for regulators, the sheer volume and complexity of rules leaves little choice but to reduce supervision to box-ticking. This risk will be amplified beyond reason if there is not a co-ordinated approach to the application of the new regime to international groups. Bankers and supervisors need to manage these risks in a sensible and pragmatic fashion.

Individually, these concerns may undermine the level-playing field the Basel Committee is trying so hard to protect. Together, they create the risk of competitive disparity, as the exercise of national discretion and different implementation approaches alters the competitive balance between domestic, national and internationally active banks. The current proposals will create 'winners' and 'losers', possibly to a greater extent than the Basel Committee would deem acceptable or desirable.

RECOMMENDATIONS

Regulators and bankers alike are at a critical point in the Basel process, as this round of consultation is probably the final opportunity for change at the global level. Therefore, we would recommend that the Basel Committee consider the following proposals that are aimed to increase flexibility and improve the likelihood of successful implementation.

1) Flexibility.

The concerns outlined above, many of which have been voiced from within the regulatory community, would be partially mitigated if the scope and timeline for implementation of the Accord were made more flexible:

- **Permanent Partial Use:** Banks should be allowed to use the complete range of Basel 2 approaches within their business on a portfolio-by-portfolio basis, where local circumstances or data availability/risk characteristics dictate it. The Committee has previously discounted similar proposals because of concerns around 'cherry-picking' or 'gaming', but we believe that this risk is overstated, and could pragmatically be resolved through regulatory oversight and/or Pillar 2.

- **Single IRB for Wholesale:** The Basel Committee should combine the Foundation (FIRB) and Advanced (AIRB) approaches into a 'single IRB' for Wholesale, allowing banks to use either approach under one IRB umbrella. This would allow banks to evolve their practices on a portfolio-by-portfolio basis, as data quality and availability improved. This recommendation is different from the permanent partial use proposal in one key respect, as to optimise the benefit, the Basel Committee should adopt a consistent set of assumptions to underpin both the Foundation and Advanced approach. This recommendation would eliminate the 'cliff effects' and perverse incentives that currently exist in the Basel 2 calibrations.

- **Retaining Basel 1:** Within the Transition rules as proposed in the UK, Banks looking to adopt an Advanced approach for credit risk could move their portfolios onto the FIRB/AIRB framework at any stage between 2007 and 2009. However, any portfolio migrating to the advanced approach after 31st December 2006 would, technically, need to adopt the Standardised approach as an interim step.

  The FSA has suggested that banks should have the flexibility to keep these portfolios on Basel 1 until they qualify for AIRB. We support this proposal, as it would avoid banks having to take an awkward implementation step. As important, such a proposal would allow banks and the regulatory authorities to focus efforts and resources on getting portfolios ready and approved for IRB by 2006, thereby reducing the regulatory stretch inherent within the current proposals. The Basel Committee would provide even greater flexibility if it allowed banks to retain Basel 1 for those portfolio's acknowledged to be "immaterial", rather than forcing firms to adopt a Standardised approach.

  Assuming this proposal is taken forward at the Basel level, we would welcome further clarity as to how the transitional capital floors (90% in year 1, 80% in year 2 etc) and the Pillar 3 disclosure requirements will operate during the transition period.

- **Evolution, rather than revolution:** the Committee should consider having staggered implementation dates for different portfolios. For example, the Committee could propose 31st December 2006 for retail, and defer implementation for corporate portfolios until end 2007. This would help reduce the burden on firm's and regulators, and enable the proposals to be amended based on actual experience.

2) Principles-based, rather than rules based, Accord.

A pragmatic solution to the complexity within the Accord would be to adopt a more principles, rather than rules-based approach to regulatory capital calculation that will stand the test of time and truly encourage enhancements in the management of risk and capital. In this regard, the Basel Committee should reconsider the following technical areas:

- **SME Boundary**: The hard boundary at €1 million is illogical, and creates real complexity in implementation. There are some retail customers, using retail products, who will fall foul of this requirement. It would be far more pragmatic to have a principle that retail customers/products are treated under the retail curves, and should any of these exceed the €1 million boundary, then a compensating charge will be made within Pillar 2.

  The other problem with this boundary is that it is expressed in €uro's. Over the past six months, there have been significant exchange rate fluctuations between this currency and Sterling (and the US $), fluctuations which would give rise to changes in capital requirements, not because of some change in underlying risk within the portfolio, but because of a change in retail/corporate definition caused purely as a change in an external economic variable. This seems inappropriate and will only serve to confuse those who wish to compare results through Pillar 3.

  A possible unexpected consequence of the Committee's approach in this area may be the removal of financing for firms around the boundary; it will become too expensive for banks to deal with the operational requirements.

- **Definition of Default:** The "back-stop" Definition of Default is too simplistic and does not reflect the range of measures already used across the marketplace. As a result, banks who have advanced from simply measuring days past due will be unfairly penalised. More sophisticated banks will need to run two sets of definitions - one for regulatory capital management purposes, the other for the effective management of their business. In this area, the approach adopted by the Basel Committee will stifle innovation in risk management.

The Basel Committee should be less prescriptive regarding the credit risk rules, and balance this with a much greater emphasis on supervisory review. Risk management is a balance between art and science and involves management judgement. The same is true of supervision.

There are many other areas of technical concern, but as these are outlined in various trade body responses, we are not duplicating them here.

3) International framework - The Home: Host Issue.

Whilst considerable work has already been undertaken in Basel in designing the framework, there are signs that the goal of consistent application is breaking down. Whereas the Basel 1 rulebook is fairly short and fairly simple, so the scope for divergence between national supervisors is limited, the new Basel rulebook is neither short, nor simple - and the scope for divergence is substantial.

The current approach to international co-ordination and co-operation, while presenting its own challenges, nevertheless is sustainable. The new approach is not. What banks need is a practical and effective solution to the home - host issues. Operating a single version of Basel 2 will be challenge enough; operating multiple versions will be unnecessarily onerous.

4) Calibration.

The Committee should reconsider the current calibration and make improvements at the portfolio level to remove the 'cliff effects' and perverse incentives that exist within the current proposals. In addition, the Committee should consider running an additional QIS during 2005, and recalibrating the Accord based on its outcome. Such results should be confirmed through the parallel run from 2006.

5) Disclosure.

RBS regard greater risk disclosure as an opportunity - we have a good story to tell about the quality of our portfolio and our risk management and control processes. However, despite improvements in the CP3 proposals, we remain concerned about the scale and granularity of the requirements and encourage the Basel Transparency Group to reconsider the input provided to them by banks and Trade Associations.

However, given the general lack of understanding about Basel 2 in the market, there is considerable risk in moving straight to a full disclosure regime based on an untested measurement methodology. We believe that the Basel Committee should adopt a more pragmatic approach to market disclosure, with more qualitatively based requirements evolving gradually in line with investor and market education. We need to learn, our supervisors need to learn and the market needs to learn. Reputational damage through ill-considered disclosure will not be easily repaired.
With this in mind, we recommend that the Basel Committee also consider delaying implementation of Pillar 3 until the end of the formal transition period; consistent disclosure before this is likely to be undermined by different national implementation assumptions and approaches.

Conclusion

Given openly stated views by regulators that they cannot rely on the output of the (AIRB) models, there is clearly a requirement for further work and revision. Making the Accord more prescriptive, trying to close every loophole is not the answer, and can only serve to move banks into a "one-size-fits-all" to credit and operational risk modelling. This would not benefit banks and could increase systemic risk within the system.

Rather, the Committee should use this final opportunity to make the Accord more flexible and open to management judgement on both sides. Without this, Basel 2 risks not being a global Accord, and could require work on a replacement Basel 3 before the ink is dry on this version.